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# Securities on the Internet: World Wide Opportunity or Web of Deceit?

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## COMMENT

### SECURITIES ON THE INTERNET: WORLD WIDE OPPORTUNITY OR WEB OF DECEIT?

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## I. INTRODUCTION

The Internet's roots can be traced to a military project sponsored by the United States Department of Defense Advanced Research Projects Agency (ARPA).<sup>1</sup> This project, ARPANet, was created in the wake of the Cuban missile crisis and designed as a decentralized computer network capable of surviving a nuclear war.<sup>2</sup> From its military-specific inception, the Internet has evolved into a massive global communications network capable of serving over 25 million users worldwide.<sup>3</sup>

Currently, the Internet is used to perform a far greater range of tasks than its creators ever anticipated.<sup>4</sup> For instance, the Internet has recently been used to offer and trade securities. While the use of this media as a conduit for securities transactions is certainly not the norm now, Internet stock offerings may become more common in the future. For the moment, however, regulators are trying to keep up with its rapid technological advancement, manage the existing problems, and define the role it will play in future securities regulation.<sup>5</sup>

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1. Alexander C. Gavis, *The Offering and Distribution of Securities in Cyberspace: A Review of Regulatory and Industry Incentives*, 52 BUS. LAW. 317, 317 n.3 (1996) (citing HARLEY HAHN, *THE INTERNET COMPLETE REFERENCE* 2 (2d ed. 1996)).

2. Robert C. Waters, *An Internet Primer for Florida Legal Researchers*, 70 FLA. B.J. 12, 15-16 (1996).

3. John T. Delacourt, *Recent Development: The International Impact of Internet Regulation*, 38 HARV. INT'L L.J. 207, 207 (1997).

4. See Waters, *supra* note 2, at 15-20.

5. See generally Bradford P. Weirick, *With the Internet Craze Reaching the Public-offering Markets, State, Federal, and Foreign Regulators Are Scrambling to Catch Up with Technological Advances*, NAT'L L.J., May 6, 1996, at B5.

This Comment will analyze the Internet's impact on securities regulation in the Western Hemisphere. Part II addresses the issues facing regulators by first examining the existing regulatory regime imposed under the auspices of U.S. federal securities laws. Part III examines significant developments in the offering of securities on the Internet and the challenges raised by incorporating this technology into the traditional offering system. Part IV illustrates how the Internet has been used to facilitate fraudulent securities transactions by highlighting the litigation of Internet fraud in the United States. Additionally, Part IV discusses how Internet fraud challenges securities regulators. Finally, Part V demonstrates the various initiatives taken by securities regulators in the Western Hemisphere to address issues and concerns that Internet stock offerings have precipitated.

## II. BACKGROUND: THE EXISTING REGULATORY REGIME IN THE UNITED STATES

U.S. securities markets serve two critical functions. First, they are important generators of capital for U.S. businesses and industries, and second, they provide investors with an alternative vehicle for savings and investments.<sup>6</sup> U.S. securities markets are now recognized for their depth, liquidity, and integrity; however, they were not always so highly revered.<sup>7</sup> Aspiring to protect investors and to maintain an orderly market, Congress enacted the Securities Exchange Act of 1934<sup>8</sup> (Exchange Act), whose statutory mandate established the Securities and Exchange Commission (SEC or Commission).<sup>9</sup> The Exchange Act empowered the SEC to enforce the previously legislated goals of the Securities Act of 1933 (Securities Act)—namely, the prevention of fraud and the promotion of market efficiency.<sup>10</sup> Thus, one of the principal ways this law enforcement agency protects investors is by requiring issuers of securities to fully disclose material

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6. Testimony of Arthur Levitt, Chairman, SEC, Concerning the Commission's Authorization Request for Fiscal Year 1997 Before the Subcommittee on Telecommunications and Finance Committee on Commerce United States House of Representatives, Feb. 28, 1996, available in 1996 SEC LEXIS 531, at \*5 [hereinafter Levitt Testimony].

7. See *id.* at \*24.

8. See generally 15 U.S.C. § 78aa (1994).

9. Levitt Testimony, *supra* note 6, at \*6; 15 U.S.C. § 78a-78ll (1994).

10. Michael E. Schoeman, *The First Amendment and Restrictions on Advertising of Securities Under the Securities Act of 1933*, 41 BUS. LAW. 377 (1986).

information.<sup>11</sup> With this goal in mind, the SEC regulates offerings and sales in the primary market under the mandate of the Securities Act, while it regulates trading in the secondary market and imposes continuous disclosure requirements on issuers under the Exchange Act.<sup>12</sup> However, both Acts impose liability for fraud through antifraud provisions.<sup>13</sup> This Comment will focus solely on the regulation of public offerings and fraud. It is within this framework that the effects of the Internet on securities regulation in the Western Hemisphere will be analyzed.

### III. THE MERGING OF INTERNET TECHNOLOGY WITH THE OFFER-BASED REGULATORY SYSTEM

It is exceedingly difficult to monitor and control the information that gets on the Internet. This lack of control creates challenges that are incompatible with continued reliance on an offer-based system that closely regulates all pre-sale communication, such as the existing regulatory regime in the United States. Under the offer-based system in the United States, traditional public offerings are regulated pursuant to Section 5 of the Securities Act.<sup>14</sup> The method of regulation that has evolved under Section 5 is premised on the regulation of both offers and sales of securities.<sup>15</sup> Disclosure is controlled and regulated prior

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11. Levitt Testimony, *supra* note 6, at \*6.

12. See 15 U.S.C. §§ 77a-77aa (1994); see also *id.* §§ 78a-78ll.

13. See *id.* §§ 77l(2), 77q, and 78j(b).

14. Section 5 of the Securities Act of 1933 regulates the registration and offering of a security. *Id.* § 77e(c). Section 5 makes unlawful use of the mail, transportation, or communication in interstate commerce to sell a security unless a registration statement is in effect and further makes it unlawful to offer a security through these means unless a registration statement has been filed. *Id.* A registration statement consists of a prospectus, which is disseminated to the public and supplementary information filed with the SEC, which is available for the public to inspect. Carl W. Schneider et al., *Going Public: Practice, Procedure, and Consequences*, 21 VILL. L. REV. 1, 10 (1981).

15. Publication of Information Prior to or After the Effective Date of a Registration Statement, Securities Act Release No. 33,3844, 22 Fed. Reg. 8359 (1957). The public offering is divided into the pre-filing period, the waiting period and the post effective period. Bart J. Colli & Debra S. Groisser, *Raising Capital Carefully Under SEC's New Rules*, N.J.L.J., Feb. 13, 1995, at 36. During the period prior to the filing of a registration statement an issuer must avoid "the issuance of forecasts, projections, or predictions relating, but not limited to revenues, income or earnings per share and the publication of opinions concerning values." *Id.* During the waiting period no sales are permitted and offers are permitted only if they are oral or made by a preliminary prospectus meeting the requirements of Section 10 of the Securities Act. *Id.*; Schneider et al., *supra* note 14, at 22-23. Violators of Section 5 may face civil liability under Section 12(1) of the Securities Act of 1933. 15 U.S.C. § 77l(a)(1) (1994).

to the filing of a registration statement until the point of sale and delivery of a final prospectus.<sup>16</sup> Hence, written materials must satisfy the requirements for disclosure set forth in the Securities Act.<sup>17</sup>

There is an important motive for establishing a regulatory structure such as this. The structure was created to ensure that investors would receive accurate and material information prior to their purchase, thereby allowing investors to make a reasonable determination of the integrity of the security offered.<sup>18</sup> Additionally, such a structure helps prevent "market conditioning," which occurs when an issuer attempts to stimulate interest in an offering before filing a registration statement.<sup>19</sup> The market conditioning is often based on incomplete, misleading or fraudulent information. This may cause a stock to sell at an artificially inflated price, and as a result, the value of the stock will not be as great as the investor believed it to be.

The Internet is incompatible with this offer-based system for several reasons. First, the information posted on the Internet can be forwarded to investors world-wide almost instantaneously.<sup>20</sup> In fact, data on the Internet can be transmitted at speeds of up to two billion bits per second, which "would enable the entire Encyclopedia Britannica to leave a New York computer and arrive at a California terminal in under two seconds."<sup>21</sup> Such speed in the offering of securities may not be desirable, for the SEC has noted that:

[o]ne of the cardinal purposes of the Securities Act is to slow down this process of rapid distribution of corporate securities,

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16. See 15 U.S.C. § 77e(c)(1994).

17. See *id.*; see also FRANCIS M. WHEAT, SEC, DISCLOSURE TO INVESTORS; A REAPPRAISAL OF ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS 127 (1969) [hereinafter THE WHEAT REPORT].

18. See JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 215 (1991) (stating that Section 5 of the Securities Act's registration statement filing requirement—including "information about the security's issuer, the security, contemplated uses of the offering's proceeds, and the manner of its sale"—has "the intended purpose of facilitating informed investment decisions and discouraging the fraudulent promotion of worthless securities"); see also THE WHEAT REPORT, *supra* note 17, at 10 ("Disclosure is and has from the outset been a central aspect of national policy in the field of securities regulation.").

19. See COX ET AL., *supra* note 18; see also Colli & Groisser, *supra* note 15.

20. George P. Long, III, *Who are You?: Identity and Anonymity in Cyberspace*, 55 U. PITT. L. REV. 1177, 1182 (1994).

21. *Id.* at 1180.

at least in its earlier and crucial stages, in order that dealers and investors might have access to, and an opportunity to consider, the disclosure of the material business and financial facts of the issuer provided in registration statements and prospectuses... The entire distribution process was often stimulated by sales literature designed solely to arouse interest in the securities and not to disclose material facts about the issuer and its securities.<sup>22</sup>

Second, in addition to the accelerated speed of Internet offerings, creative issuers who offer securities on the Internet are able to combine written text, graphics, and audio soundtracks to persuade investors that their securities are good investments.<sup>23</sup> This sales method may be much more effective than a letter or a phone call alone. Combining all of these forms of communication into one medium may create a more persuasive package.

Finally, the decentralization of the Internet makes it more difficult to regulate.<sup>24</sup> This is principally because different methods for accessing information may be necessary at different sites, accessing some sites may require knowledge of complicated computer languages, sites may contain unique information, and there is not a complete Internet directory of providers.<sup>25</sup>

Together, these elements make continued reliance on the regulation of pre-sale communications unmanageable. Therefore, to provide effective regulation of Internet offerings, an alternative regulatory regime must be imposed.

### *A. Revolutionizing the Initial Public Offering*

Historically, paper-based communication has been instrumental in effecting traditional securities offerings.<sup>26</sup> Yet, with the increasing popularity of the Internet, issuers saw a way to facilitate capital formation by lowering communication costs be-

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22. Carl M. Loeb, Rhoads & Co., 38 S.E.C. 843, 849 (1959) (*cited in* THE WHEAT REPORT, *supra* note 17, at 129-30).

23. Use of Electronic Media for Delivery Purposes, Securities Act Release No. 33,7234, 60 Fed. Reg. 53,468 (1995) (to be codified at 17 C.F.R. pts. 231, 241, and 271) (proposed Oct. 13, 1995).

24. Long, *supra* note 20, at 1181.

25. *Id.*

26. See Use of Electronic Media for Delivery Purposes, 60 Fed. Reg. at 53,468; see also Weirick, *supra* note 5.

cause the Internet can reach many more people at no additional cost.<sup>27</sup> Pioneering this advancement, Spring Street Brewing Company launched the world's first initial public offering (IPO) executed entirely over the Internet.<sup>28</sup>

In the Spring Street Brewery offering, Andrew Klein, Spring Street's president and chief executive officer, directly solicited investors to raise capital for his company.<sup>29</sup> Klein "saw it (the Internet) as a direct channel to investors and an efficient way to get our prospectus out to a lot of people."<sup>30</sup> Without an underwriter, the unprecedented Internet offering took place in February 1995, whereby Spring Street successfully raised \$1.6 million by selling 870,000 shares to 3500 investors.<sup>31</sup> In offering its securities, Spring Street took advantage of the Regulation A offering exemption, which provides an exemption from federal registration requirements for companies conducting intrastate offerings of \$5 million or less in a twelve month period.<sup>32</sup> The event was described as "the shot heard 'round the world."<sup>33</sup> And so it was. As word about the success circulated, Klein received over 600 calls from business owners who wanted to follow the path that he had pioneered.<sup>34</sup>

Even for Klein, the Spring Street Brewery IPO was just the beginning. He also engineered Wit Trade, a bulletin board-based trading system, which facilitated the matching of buyers and sellers of Spring Street stock.<sup>35</sup> Once matched, Spring Street completed the trade upon receipt of the contracting parties'

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27. *Wallman Urges Consideration of Offerings Published Offshore on Internet*, Sec. Reg. & L. Rep. (BNA) No. 43, at 1338 (Nov. 1, 1996) [hereinafter *Wallman Urges Consideration*].

28. *Staff Clears Way for NY Concern to Resume Stock Trading on Internet*, BNA Sec. L. Daily, Mar. 27, 1996, available in LEXIS, BNA Library, BNASLD File [hereinafter *Staff Clears Way*].

29. Dinah Zeiger, *Going Public in Cyberspace Internet Offers Way to Launch Start-ups*, DENV. POST, June 10, 1996, at E12.

30. *Id.* (alteration in the original).

31. *Id.*

32. Greg Allio & Gary Lloyd, *Webstock; The Latest Internet Love-In will be the Direct Selling of Shares*, RECORDER, July 3, 1996, at 6; 17 C.F.R. § 230.251 (1997). A Regulation A exemption is only available to issuers that are not investment companies or Exchange Act reporting companies. *Id.*

33. Zeiger, *supra* note 29.

34. Allio & Lloyd, *supra* note 32.

35. *SEC Clears Trades of Spring Street Stock on Internet*, N.Y. TIMES, Mar. 26, 1996, at D4; *Brewery Wins OK for Internet Trading*, TIMES UNION (Albany, N.Y.), Mar. 26, 1996, at B9.



money and stock certificates.<sup>36</sup> However, this venture was stalled temporarily when Spring Street voluntarily suspended trading due to concerns raised by the SEC.<sup>37</sup> In its April 17, 1996 no-action letter, the SEC recommended that Spring Street implement certain changes.<sup>38</sup> The SEC was concerned with unregulated broker-dealer activity because Spring Street was not a registered broker-dealer.<sup>39</sup> In essence, the SEC wanted to ensure that investors' funds were handled properly.<sup>40</sup>

Thus, Spring Street first needed to eliminate its control over investors' funds.<sup>41</sup> To handle these funds, the SEC suggested the alternative of employing an independent agent.<sup>42</sup> The SEC also wanted Spring Street to warn investors of the risks involved in purchasing illiquid securities and to provide investors with a transaction history so they could make informed investment decisions.<sup>43</sup> Furthermore, the SEC characterized sales through Wit-Trade as sales or offers for the purposes of the Securities Act.<sup>44</sup> Therefore, it was necessary for Spring Street to fulfill the Act's registration requirements unless the offering qualified for an exemption.<sup>45</sup> Upon amending its procedures to comply with these qualifications, the SEC has since allowed Spring Street to resume trading on Wit-Trade.<sup>46</sup>

During the same period of time, Andrew Klein announced plans for another endeavor, Wit-Capital.<sup>47</sup> Wit-Capital was designed to underwrite and promote IPOs on the World Wide

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36. *SEC Clears Trades of Spring Street Stock on Internet*, N.Y. TIMES, Mar. 26, 1996, at D4.

37. *Brewery Wins OK for Internet Trading*, TIMES UNION (Albany, N.Y.), Mar. 26, 1996, at B9.

38. Spring Street Brewing Co., SEC No-Action Letter, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,201, at 77,002 (Apr. 17, 1996).

39. Interpretation Regarding Use of Electronic Media, 61 Fed. Reg. 42,146, at 42,148 (1996) (to be codified at 17 C.F.R. pt. 4.); Spring Street Brewing Co., *supra* note 38.

40. Spring Street Brewing Co., *supra* note 38, at 77,001.

41. *Staff Clears Way*, *supra* note 28.

42. Spring Street Brewing Co., *supra* note 38, at 77,001.

43. *Id.* at 3; see also Interpretation Regarding Use of Electronic Media, 61 Fed. Reg. at 42,148.

44. Spring Street Brewing Co., *supra* note 38, at 77,002.

45. *Id.*

46. *Brewing Company Founder Cites Plans For Internet Investment Bank, Brokerage*, BNA Sec. L. Daily, Apr. 3, 1996, available in LEXIS, BNA Library, BNASLD file [hereinafter *Brewing Company*].

47. *Id.*

Web.<sup>48</sup> In regards to this undertaking, Klein said he was planning to "build the world's first investment bank and brokerage firm dedicated to arranging the public offering of securities through the World Wide Web."<sup>49</sup> As to future developments, Klein said he "also plans to develop and operate on the World Wide Web a digital stock exchange" for secondary trading of securities, "an array of financial advisory services," and a "financial marketplace" on the Internet "through which the official offering documents of issuers coming public through the (Wit Capital) will be accessible and through which such public offerings will be sold."<sup>50</sup> According to Klein, "this novel investment vehicle would guarantee [that] investors would be purchasing shares in public offerings ... directly from the issuer."<sup>51</sup>

Other companies have been involved in the integration of electronic media into the offering process as well. One of these companies, Real Goods Trading Corporation, established a bulletin board to post identifying information about interested buyers and sellers of its common stock, the quantity of stock these investors wanted to buy or sell, and the date the information was put into the system.<sup>52</sup> The company would neither be involved in the offering transactions, nor would they receive compensation or provide investment advice, so the SEC granted no-action status to this arrangement on June 24, 1996.<sup>53</sup>

Despite the enthusiasm for rapid developments in this technology, the evolution of a completely electronic public offering marketplace may proceed at a much slower pace. Some observers are skeptical about whether investors will participate in early Internet offerings similar to the Regulation A offering conducted by Spring Street.<sup>54</sup> Because these offerings are so small and the issuers are not generally listed on an exchange, the secondary market for these stocks is minimal, leaving investors

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48. *Id.* The World Wide Web "is a new set of 'protocols' for transferring information" that "sends information over the Internet in a way that can be displayed in an eye-pleasing, easy-to-use format on computer screens." Waters, *supra* note 2, at 20.

49. Brewing Company, *supra* note 46.

50. *Id.*

51. *Id.*

52. Real Goods Trading Corp., SEC No-Action Letter, [1996-1997 Binder] Fed. Sec. L. Rep. (CCH) 77,226, at 77,132 (June 24, 1996).

53. Interpretation Regarding Use of Electronic Media, 61 Fed. Reg. at 42,148.

54. Allio & Lloyd, *supra* note 32.

with illiquid investments.<sup>55</sup> Therefore, the companies likely to be successful in early Internet IPOs will be those with "affinity investors."<sup>56</sup> However, Internet public offerings have not yet attained the liquidity of full secondary market trading.<sup>57</sup>

Assuming there will be a market for their securities, issuers intending to use the Internet as a vehicle for public offerings still may face serious liability issues regarding compliance with the laws of virtually every jurisdiction in the world.<sup>58</sup> For example, consider the situation that occurs when a U.S. issuer posts offering materials on the Internet. While the posting of these materials may be lawful under SEC rules, this information can be accessed by individuals in foreign countries where such an offering may be unlawful.<sup>59</sup>

While the fear of possible illiquidity of investments and the uncertain resolution of jurisdictional issues may impede advancement, they will not stop it.<sup>60</sup>

### *B. Challenges Presented: Unequal Regulation and the Elimination of the Underwriter*

By June 1996, slightly more than one year after Spring Street launched its unprecedented IPO, approximately six companies were scheduled to conduct their own IPOs over the Internet.<sup>61</sup> The Internet and its millions of users offer the possibility of direct stock sales by companies that cannot otherwise hope to access the capital market.<sup>62</sup> Small companies can save substantial transaction costs by using the Internet instead of traditional paper-based transactions.<sup>63</sup> The Internet levels the playing field for these small issuers by reducing their offering costs, thereby providing them access to investment opportunities previously re-

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55. *Id.*

56. *Id.* Affinity investors are investors who are familiar with an issuer's product and use it because they like it. *Id.*

57. *Id.*

58. Weirick, *supra* note 5.

59. Interpretation Regarding Use of Electronic Media, 61 Fed. Reg. at 42,148.

60. *Staff Clears Way*, *supra* note 28; *see generally* Use of Electronic Media for Delivery Purposes, 60 Fed. Reg. at 53,468.

61. Zeiger, *supra* note 29.

62. *Id.*

63. *Id.*

served for larger investors.<sup>64</sup>

However, as former SEC Commissioner Steven M.H. Wallman advised, the Web poses an international problem in that it results in unequal regulation of domestic and foreign securities.<sup>65</sup> To demonstrate these challenges, Wallman posed a hypothetical situation in which a foreign exchange posts its quotations on the Internet so that a U.S. investor may be able to purchase those securities.<sup>66</sup> The inequity arises due to the fact that U.S. Exchanges are subject to extensive regulations, while foreign corporations will have the same access to American investors as U.S. corporations, without the extensive regulation that U.S. corporations face.<sup>67</sup> This may make it more difficult for U.S. corporations to raise capital.<sup>68</sup> Wallman offered three possible approaches to remedy this inequity: 1) impose U.S. securities laws on foreign exchanges; 2) develop the technology to block foreign issuers access to U.S. investors on the Internet; or 3) eliminate all regulations and let the market regulate itself.<sup>69</sup>

None of these approaches provides an easy solution. Indeed, no easy solution exists. However, a modification of the first approach may be the best solution. Regulators need to work together to raise the standard of regulation globally so that all investors will be better protected. This coordination would alleviate the burden of unequal registration because the rules would impose similar conditions in each country. Yet, this goal is idealistic and perhaps unattainable. Several impediments stand in the way of obtaining the agreement of every nation.<sup>70</sup>

Critics address the fairness issue of international competitive challenges by noting that most major foreign markets currently allow U.S. companies to issue securities in their countries without conforming to the home country's regulatory rules.<sup>71</sup>

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64. *Id.*

65. *Internet Issues Challenge SEC Regulation, Wallman Says*, BNA Sec. L. Daily, Mar. 5, 1996, available in LEXIS, BNA Library, BNASLD File [hereinafter *Internet Issues*].

66. *Id.*

67. *Id.*

68. *Id.*

69. *Id.*

70. For a discussion of these impediments, see Peter E. Millspaugh, *Global Securities Trading: The Question of a Watchdog*, 26 GEO. WASH. J. INT'L L. & ECON. 355 (1992).

71. James L. Cochrane, *Are U.S. Regulatory Requirements for Foreign Firms Appropriate?*, 17 FORDHAM INT'L L.J. 558 (1994).

This seems to indicate that U.S. companies have been benefiting from the unequal regulation foreign issuers have faced, but that they do not want foreign issuers to take advantage of the inequities U.S. companies face.

Another challenge posed by the Internet is that it eliminates the underwriter. This results in eliminating an important check on the system because the underwriter is an essential player in the policing of traditional company offerings. This structural deficiency is analogous to the situation posed by Rule 415.<sup>72</sup> In Rule 415 IPOs, the registration statement is prepared solely by the issuer, rather than in conjunction with an underwriter, thereby reducing the underwriter's ability to provide a due diligence review of the registration statement.<sup>73</sup> However, Rule 415 issues are the type of distributions that may easily accommodate a sacrifice in due diligence because they usually involve debt offerings, where the risks to investors are usually reduced.<sup>74</sup> By contrast, Internet offerings seem to provide a heightened opportunity for fraud, and therefore, should receive more rigorous regulation rather than less.

The Spring Street experience demonstrates that issuers do not need to use an underwriter when offering securities on the Internet. Consequently, Philip Feigin, Colorado Securities Commissioner stated "that buyers have to be more alert and check things out for themselves."<sup>75</sup> In an effort to compensate for the absence of an underwriter, some clearinghouses are now imposing tougher requirements on small companies than those that traditional underwriters impose.<sup>76</sup>

#### IV. THE INFLUENCE OF INTERNET TECHNOLOGY ON THE REGULATION OF FRAUD

While the Internet facilitates solicitation by legitimate businesses, the Internet also makes it easier for illegitimate busi-

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72. Rule 415 provides for "shelf registration" in that it allows an issuer to file a registration statement and sell its securities on a continuous or delayed basis. 17 C.F.R. § 230.415 (1997).

73. Joel Seligman, *The Obsolescence of Wall Street: A Contextual Approach to the Evolving Structure of Federal Securities Regulation*, 93 MICH. L. REV. 649, 689 (1995).

74. *Id.*

75. Zeiger, *supra* note 29.

76. *Id.*

nesses to reach the public.<sup>77</sup> According to Philip Feigin, this is a problem for regulators because there is almost no way to police the content of the material on the Internet.<sup>78</sup>

The process of policing traditional securities fraud involves the critical step of finding the guilty party. In undertaking this responsibility, an investigator may gather evidence by interviewing the victims of the alleged fraud. Many of these investors may have kept records of their transactions. Such records may form a paper trail from which the investigator may learn of any oral representations made by an issuer or broker-dealer and any written materials that were provided to the investor. While this method may enable an investigator to determine who committed the fraud, the greater difficulty generally rests in proving the other elements necessary to prosecute a violation of federal securities laws.<sup>79</sup>

In contrast, the Internet raises concerns in the fundamental levels of investigation. Using the Internet as a conduit for fraud has the advantage of anonymity, which is not easily maintained in traditional fraudulent security offerings. Enforcement may be hindered further by the jurisdictional issues inherent in the global nature of Internet offerings. Even when the SEC knows who the issuer is, it may have difficulty asserting its jurisdiction over the violator, or it may simply be unwilling to bring enforcement proceedings. Additionally, enforcement capabilities may be limited if resources do not increase in proportion to the increase of IPOs on the Internet.

While enforcement of Internet securities fraud may be difficult, it is not impossible. The SEC has had some success finding and prosecuting violators. These case studies in successful enforcement will be highlighted next.

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77. *Id.*

78. *Id.*

79. While Section 12(1) provides civil liability for violations of Section 5, Section 12(2) of the Securities Act imposes civil liability on any person who offers or sells any security by means of a material misstatement or omission of material fact. LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION § (2)(B)(1)(a) (1995). Section 17 of the Securities Act is a general antifraud provision applicable to the sale of securities regardless of an exemption from registration. *Id.* Section 10b-5 of the Exchange Act of 1934 has been characterized as a "catch-all" provision. *Id.* § (9)(B)(3). In pertinent part it provides that it is unlawful for a person to use any means of interstate commerce to employ any device, scheme or artifice to defraud. See 17 C.F.R. § 240.10b-5 (1997).

A. *Fraud in the Marketplace: An Overview of the Cases*

In examining U.S. litigation of securities fraud on the Internet, the cases can be divided into two main categories. The first series of cases focus on misrepresentations in securities offerings, while the second series of cases depict instances involving market manipulation.

The SEC brought one of its first cases involving fraudulent promotions of securities on the Internet, *SEC v. Pleasure Time, Inc.*, on March 13, 1995.<sup>80</sup> In that case, the SEC alleged that Pleasure Time, Inc. and others raised over \$3 million by offering and selling unregistered securities to investors who sought to profit from the establishment of a global telephone lottery.<sup>81</sup> However, the defendants fraudulently failed to disclose impediments to this promotion.<sup>82</sup> On November 26, 1996, Pleasure Time was permanently enjoined from future violations of Sections 5(a), 5(c), and 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10(b)-5 promulgated thereunder.<sup>83</sup>

Within five months, the SEC brought enforcement proceedings against Daniel Odulo for violations of the antifraud statutes.<sup>84</sup> The SEC in *SEC v. Odulo* alleged that Odulo used the Internet as a vehicle to solicit investment in an enterprise aimed toward the acquisition and procreation of eels.<sup>85</sup> However, his solicitations were false and misleading because they implied the business was established, when in fact it was a new venture.<sup>86</sup> He also bolstered his solicitations with fabricated endorsements.<sup>87</sup> While Odulo neither admitted nor denied these allegations, he consented to the entry of final judgment in the form of a permanent injunction against future violations of Section 17 of

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80. Gavis, *supra* note 1, at 346.

81. *SEC v. Pleasure Time, Inc.*, Litigation Release No. 14,825, 1996 SEC LEXIS 510 (S.D. Ohio Feb. 26, 1996); *SEC v. Pleasure Time, Inc.*, Litigation Release No. 15,178, 63 S.E.C. Docket (CCH) 1006 (S.D. Ohio Dec. 6, 1996).

82. *Pleasure Time, Inc.*, 1996 SEC LEXIS 510, at \*2; *Pleasure Time, Inc.*, 63 S.E.C. Docket (CCH) at 1006.

83. *Pleasure Time, Inc.*, 63 S.E.C. Docket (CCH) at 1006.

84. *SEC v. Odulo*, Civ. Action No. 95-424P, 1995 SEC LEXIS 2062 (D.R.I. Aug. 7, 1995).

85. *Id.*

86. *Id.*

87. *Id.*

the Securities Act, Section 10 of the Exchange Act and Rule 10(b)-5.<sup>88</sup>

In several similar suits, foreign promoters targeting U.S. investors fraudulently solicited investments in Canadian,<sup>89</sup> Costa Rican,<sup>90</sup> and Panamanian<sup>91</sup> enterprises. In each instance, material misrepresentations were made regarding the principal investment vehicle. In some cases, the offerings were found to be complete and total shams.<sup>92</sup>

Even a promoter who was a convicted criminal and had violated federal securities laws in the past allegedly managed to use Internet advertisements to solicit investors.<sup>93</sup> Specifically, in Oc-

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88. *Id.*

89. SEC v. Wye Resources, Inc., Litigation Release No. 15,073, 62 S.E.C. Docket (CCH) 2533 (D.D.C. Sept. 26, 1996). From June 24, 1993 to May 25, 1994, Wye, a Canadian Corporation headquartered in Toronto, and its president, Rehan Malik, attempted to distribute 5.3 million shares of Wye stock using a New Orleans based bulletin board service to place messages on the Internet and advertise in U.S. publications. *Id.* The representations Wye made therein were false and misleading. *Id.* Wye claimed to have found ten diamonds in its Zairian mine, yet these diamonds did not come from the mines. *Id.* They were actually purchased. *Id.* Wye contractors had never even been to the mines. *Id.* Although five million shares were originally issued to U.S. investors, four million shares of Wye outstanding stock were still held by unsuspecting U.S. investors in February 1994. *Id.*

90. SEC v. Frye, Litigation Release No. 15,139, 1996 SEC LEXIS 3016 (S.D.N.Y. Oct. 29, 1996). In May 1995, Scott Frye posted messages on the Internet, attempting to find investors for two Costa Rican enterprises, ICD and Jupiter Agro Development Project. *Id.* Frye had represented that one of these companies had a major distribution contract with A&P Supermarkets, which was false. *Id.* Based on these misrepresentations, Scott Frye was permanently enjoined from committing future violations of the federal securities laws on August 17, 1996. *Id.*

91. SEC v. Octagon Tech. Group, Litigation Release No. 14,942, 62 S.E.C. Docket (CCH) 380 (D.D.C. June 11, 1996). Octagon Technology Group and its officers conducted a sham offering of offshore debt securities with the help of the Internet. *Id.* On a World Wide Web homepage and related pages for the Agency for Interamerican Finance (AIF), a Panamanian shell subsidiary of Octagon, "Interamerican hard currency bonds" were advertised for sale. Prospective investors were falsely promised a risk free investment with guaranteed returns of 11.75% annually. *Id.* Furthermore, money invested could be doubled in six years, the pages claimed. *Id.* The pages also represented AIF as a successful provider of investment capital to Latin American businesses. *Id.* To the contrary, there were no bonds and AIF had no business operations or assets. *Id.* Also lacking assets was American Pacific Financial, Ltd., S.A., a Panamanian shell subsidiary of Octagon which the pages claimed backed the bonds. *Id.* Moreover, a fabricated investment article was included. *Id.* Clearly, these Web pages included several false statements. *Id.* As a result, Octagon and its officers were enjoined from committing future violations of the antifraud provision of the Securities Act of 1933, Section 17(a). *Id.*

92. *Wye Resources, Inc.*, 62 S.E.C. Docket (CCH) 2533; *Octagon Tech. Group*, 62 S.E.C. Docket (CCH) 380.

93. *SEC Obtains TRO in Case Involving Internet Offering*, 28 Sec. Reg. & L. Rep. (BNA) No. 31, at 944 (Aug. 2, 1996).



tober 1995, William Sellin used Internet bulletin board postings as a conduit for fraudulent securities offerings.<sup>94</sup> With respect to the advantages of using the Internet to commit fraud, the SEC commented that "[t]he Internet provides promoters, such as Sellin, with direct access to millions of prospective investors worldwide with great speed and ease, minimal expense and virtual anonymity."<sup>95</sup> Seizing this opportunity, Sellin solicited investments in promissory notes purportedly backed by U.S. government securities and other assets by advertising in at least twenty-one Internet newsgroups.<sup>96</sup> However, the investments were neither secured nor collateralized by government securities, and the SEC claims Sellin failed to disclose material risks inherent in the investments.<sup>97</sup> Consequently, on August 1, 1996, a Final Judgment of Permanent Injunction was entered against Sellin, enjoining him from violating Section 17(a) of the Securities Act and Section 10 of the Exchange Act.<sup>98</sup>

"Pumps and dumps" on the Internet cause a similar problem for regulators. These are market manipulation schemes designed to stir up investor enthusiasm and to inflate the price of the security.<sup>99</sup> Typically, offenders hold shares of a stock previously purchased for a minimal amount of money, and they try to inflate the share value in the market so they can sell them for a big profit.<sup>100</sup> The injustice occurs when the investor buying the stock at the artificially inflated high price is left with a stock that is really worth little or nothing. While similar schemes endured for years without the aid of the Internet, the Internet has become an attractive tool in the furtherance of such schemes.<sup>101</sup>

The first case brought by the SEC allegedly involving market manipulation through the Internet was against Systems of Excellence, Inc. (SEXI).<sup>102</sup> In this case, Charles Huttoe allegedly posted false press releases and unsupported earnings projections

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94. *Id.*

95. *Id.*

96. *Id.*

97. SEC v. William B. Sellin, II, Zatech Holdings, Inc. and Baccaratt Holdings, Inc., Litigation Release No. 15,012, 1996 SEC LEXIS 2240 (S.D. Fla. Aug. 12, 1996).

98. *Id.*

99. Leslie Eaton, *Let the Cyberinvestor Beware; A Tale of Stock Promotion, Regulation and the Internet*, N.Y. TIMES, Dec. 5, 1996, at D1.

100. *Id.*

101. *Id.*

102. Jeffrey Taylor, *SEC Steps Up Attack on People Tied to Systems of Excellence Inc.*, WALL ST. J., Dec. 12, 1996, at B2.

on the Internet through an electronic newsletter, called SGA Goldstar.<sup>103</sup> The information that SGA posted was "highly promotional, strongly urging accumulation of the stock, discouraging sales and even discouraging investors from independently verifying SGA's information."<sup>104</sup> In return for this service, SEXI gave SGA principals 300,000 shares of SEXI stock.<sup>105</sup> The SEC alleged that Goldstar employees "engaged in a systematic practice of publishing promotional coverage for other issuers in exchange for compensation' and failed to disclose the compensation."<sup>106</sup> Concurrently, Huttoo had issued millions of shares of unregistered stock to himself, family members and others, reaping over \$9.7 million.<sup>107</sup> For his involvement in the manipulation, Huttoo was sentenced to forty-six months in prison, which is to be followed by two years of supervised release and payment of a \$10,000 fine.<sup>108</sup>

In a similar case, the stock of Comparator Systems was touted anonymously over the Internet, causing the stock price to become artificially inflated.<sup>109</sup> Comparator has since settled the case with the SEC, which charged that the company was responsible for the inflation in the price.<sup>110</sup>

It is clear from these cases that electronic media is used to conduct securities fraud. While it is encouraging to see that the fraud was detected in these instances, it is not difficult to imagine that a substantial amount of fraud goes undetected. Even though enforcement and prosecution of Internet securities fraud is possible, there are factors that make these processes difficult. These factors will be discussed next.

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103. *Id.*

104. David Poppe, *Internet Stock Tips Played a Role in SEXI's Rise and Fall*, Says SEC, MIAMI HERALD, Nov. 20, 1996, at 7B.

105. *Id.*

106. Taylor, *supra* note 102.

107. Poppe, *supra* note 104.

108. Jeffrey Taylor, *Ex-Chairman of Systems of Excellence Sentenced to Prison*, Dow Jones News, Feb. 2, 1997. As of February 2, 1997, the civil complaint filed by the SEC was still pending. *Id.*

109. George Mannes, *Scam Artists Con Netizens Online Gifters Use Old Tricks With New Technology*, DAILY NEWS (N.Y.), Jan. 5, 1997, at 36.

110. *Id.*

*B. Challenges Presented: Limited Resources,  
Expanding Boundaries, and Anonymity*

The SEC, with only 2797 employees across the country, has limited resources to enforce and regulate the integrity of the market.<sup>111</sup> Thus, the SEC engages the assistance of the private sector.<sup>112</sup> Much of the regulation of securities market participants is thereby delegated to the individual firms and underwriters under the traditional regulatory regime.<sup>113</sup> As a result, the underwriter typically acts as a "gatekeeper" in that it will investigate the issuer carefully before it agrees to underwrite the issue.<sup>114</sup> This investigation is designed to identify those issuers least likely to make productive use of investor's funds and to identify the degree of risk involved in the issue.<sup>115</sup> However, offerings on the Internet may tend to eliminate the underwriter, further limiting resources, and making widespread fraud more difficult to police.<sup>116</sup>

The Internet's complete lack of geographic boundaries further complicates the situation.<sup>117</sup> Wallman commented on this issue, saying that the SEC's "usual method of regulation by geographical jurisdiction is about to disappear."<sup>118</sup> Accordingly, federal regulatory efforts will be focused on the resolution of boundary and jurisdictional concerns.<sup>119</sup> Adopting a solution will not be a simple task, however, because the global structure of securities regulation embraces distinct regulatory schemes.<sup>120</sup> Greater coordination among international regulators may alleviate some of the difficulties inherent in enforcing jurisdiction and may resolve policy issues that arise as a result of such enforcement.<sup>121</sup>

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111. Levitt Testimony, *supra* note 6, at \*7.

112. *Id.* at \*6.

113. *Id.* Under the self regulatory system imposed by the federal securities laws, broker-dealers may be sanctioned if they fail to supervise their employees to ensure that they comply with the law in their trading and activities. *Id.* n.6.

114. Michael P. Dooley, *The Effects of Civil Liability on Investment Banking and the New Issues Market*, 58 VA. L. REV. 776, 785-87 (1972).

115. *Id.* at 786-87.

116. Zeiger, *supra* note 29.

117. *Internet Issues*, *supra* note 65.

118. *Id.*

119. Seligman, *supra* note 73, at 651.

120. *Internet Issues*, *supra* note 65.

121. Millsbaugh, *supra* note 70, at 363; see also *Internet Issues*, *supra* note 65.

The difficulty inherent in detecting Internet securities fraud because of the Internet's anonymous nature, poses another challenge. Investors may not really know with whom they communicated or what that person's motives were. This anonymity is inconsistent with the full disclosure mandated by the Securities Act,<sup>122</sup> and it will make the regulation of fraud much more difficult.

Colleen P. Mahoney, the Deputy Director of the SEC Division of Enforcement, discussed this issue at the 10th Annual Federal Enforcement Institute sponsored by Georgetown University Law Center.<sup>123</sup> Mahoney noted that curbing manipulative practices is a top priority of the enforcement division.<sup>124</sup> This stems from the realization that the disclosure of information facilitated by the Internet may be motivated by manipulative activity in some instances.<sup>125</sup> In these instances, the nature of the person providing the information is not always clear, nor is the source's motive for disclosure of information at that certain time.<sup>126</sup> Moreover, it is not readily apparent whether the source of the information wants the price of the security to rise or fall.<sup>127</sup> Thus, the source may be concealed and its agenda hidden. Such conditions are ripe for fraud.

In regards to the regulatory issues implicated by fraud, Robert Bertram, a Pennsylvania Securities Commission lawyer commented, "[w]e're confronted with a medium that recognizes no boundaries and creates a certain level of tension. ... It's a balancing act. Investor protection is a hallmark of an efficient market. The minute investors feel uncomfortable, the market loses efficiency. But we can't make it (selling on the Internet)

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122. The Securities Act seeks to provide for full disclosure by requiring issuers to file a registration statement with the SEC. COX ET AL., *supra* note 18. Generally, items included on a registration statement include: a thorough description of the issuer's business, property, management, extensive financial information, a review by management of the issuer's capital needs, solvency and financial performance, a full description of the rights, privileges and preferences of the offered security as well as existing capital structure of the firm, and any special risks involved. *Id.* Moreover, much of this information must also be disclosed to investors in the form of a prospectus. *Id.*

123. CFTC Official Says Internet Probes Yield Results From Those Unaware of Rules, BNA Sec. L. Daily, Oct. 24, 1996, available in LEXIS, BNA Library, BNASLD File.

124. *Id.*

125. *Id.*

126. *Id.*

127. *Id.*

too difficult."<sup>128</sup> Clearly, U.S. securities regulators face a difficult choice between upholding traditional disclosure requirements, which may discourage foreign investors from issuing here, or lessening these requirements, which may put U.S. investors at greater risk.<sup>129</sup>

## V. INITIATIVES ADDRESSING THESE CONCERNS

On October 25, 1996, Dow Jones News reported that "[g]overnment regulators are racing to address a host of issues raised as the investment community reaches out to customers via the Internet."<sup>130</sup> As regulators embark into this new territory, the solutions to the challenges they face may not be clear.<sup>131</sup> What is clear, however, is that regulators are trying to respond to the issues created by Internet IPOs.<sup>132</sup> One action already taken was the amendment of U.S. securities laws to allow for electronic delivery of offering materials.<sup>133</sup> Future actions may include the adoption of a new regulatory regime applicable to foreign offerings on the Internet that are accessible to U.S. investors and greater coordination among regulators in the Western Hemisphere.<sup>134</sup> However, despite any reforms, it will be fundamental to educate investors, so that they can protect themselves.<sup>135</sup>

### A. *Reforming the Federal Securities Laws*

#### 1. Electronic Delivery of Offering Materials

Recent SEC initiatives may spur capital formulation on the Internet.<sup>136</sup> On October 6, 1995, the SEC proclaimed its support

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128. Zeiger, *supra* note 29 (alteration in the original). Bertram is also the lawyer who drafted the Pennsylvania offering exemption and the former chair of the Internet committee on the North American Securities Administrators' Association. *Id.*

129. Seligman, *supra* note 73, at 664.

130. *Regulators Rush to Set Internet Trading Ground Rules*, Dow Jones News, News Story for N/Net 557, Oct. 25, 1996.

131. *See id.*

132. *See infra* Part V.A-D.

133. *See infra* Part V.A.1.

134. *See infra* Part V.A.2-3, V.B., and V.C.

135. *See infra* Part V.D.

136. Allio & Lloyd, *supra* note 32.

for the use of electronic media by issuing an interpretative release and proposed rule amendments.<sup>137</sup> It stated therein that the "Commission believes that the use of electronic media should be at least an equal alternative to the use of paper-based media."<sup>138</sup> The release also set forth the SEC's interpretation of the application of federal securities laws to Internet IPOs.<sup>139</sup> The rule amendments, as adopted May 9, 1996, allow issuers to electronically deliver nearly all forms of disclosure to their investors.<sup>140</sup> The use of audio, video, and similar multimedia content in electronic disclosure will be permitted, but the visual or auditory content must be described textually and filed with the SEC.<sup>141</sup>

However, these rules require the satisfaction of certain conditions. For instance, when the issuer electronically delivers documents, it must provide certainty of their delivery comparable to that of paper delivery.<sup>142</sup> Thus, if an investor has not provided the issuer with an e-mail address to confirm delivery of the notice, the issuer should deliver a paper notice by mail or other means.<sup>143</sup> Likewise, issuers need to provide investors with actual notice of the availability of the final prospectus.<sup>144</sup> Electronic delivery must also provide either the opportunity to retain that information or access equivalent to personal retention, and an issuer may need to obtain written consent from investors to use electronic delivery.<sup>145</sup> Despite all of these allowances, the SEC has not yet held that a confirmation of sale may be delivered on-line.<sup>146</sup>

As the world becomes more comfortable with computer technology and the computer literate youth of today grow older, this new form of electronic delivery may become the traditional means of transacting securities offerings. It may even be replaced by a newer form of communication. No one is really sure

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137. *Id.*; Use of Electronic Media for Delivery Purposes, 60 Fed. Reg. at 53,468.

138. Allio & Lloyd, *supra* note 32.

139. *Id.*

140. *Id.*

141. *Id.*

142. Constance E. Bagley & John Arledge, *SEC Could Ease Offerings of Securities Via the Web*, NAT'L L.J., Jan. 13, 1997, at B9; *Comply with Laws When Using Internet for Securities Transactions*, SEATTLE TIMES, Nov. 4, 1996, at E2.

143. Weirick, *supra* note 5.

144. *Id.*

145. *Id.*; Bagley & Arledge, *supra* note 142.

146. Weirick, *supra* note 5.

how the Internet will evolve in the future, but as Internet and computer technology changes, so too does the future of the securities laws.

## 2. Company Registration

Some mention has been made of adopting a company registration provision to replace the existing transactional registration system.<sup>147</sup> This type of approach, first envisioned by the American Law Institute's Federal Securities Code,<sup>148</sup> was recommended to the SEC by the Advisory Committee on Capital Formation and Regulatory Processes on July 24, 1996.<sup>149</sup> In its report, the Advisory Committee proposed steps to achieve company registration that included the following: 1) the issuer<sup>150</sup> files one registration statement<sup>151</sup> that is effective immediately and is similar to an initial short-form shelf registration statement; 2) Exchange Act reports are incorporated by reference into the registration statement; 3) the company must file updated disclosures with the Commission around the time of the offering; 4) instead of paying registration fees prior to making offers, fees would be payable at the time of the sale of securities; 5) issuers are required to adopt disclosure enhancements<sup>152</sup> to improve the quality and timeliness of disclosure; and 6) only non-routine transactions would require the physical delivery of prospectuses.<sup>153</sup> In short, company registration would allow an issuer to

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147. Securities Act Concepts, SEC Release No. 33,7314, 61 Fed. Reg. 40,044 (1996); For the Report of the Advisory Committee on the Capital Formation and Regulatory Processes (July 24, 1996), see *Report of the Advisory Committee on the Capital Formation and Regulatory Process* (visited Nov. 16, 1997) <<http://www.sec.gov/news/studies/capform.htm>>.

148. Professor Louis Loss was instrumental in the development of the American Law Institute's Federal Securities Code. Securities Act Concepts, 61 Fed. Reg. at 40,045 n.10 (citing AMERICAN LAW INSTITUTE, FEDERAL SECURITIES CODE (1980)); Louis Loss, *The American Law Institute's Federal Securities Code Project*, 25 BUS. LAW. 27 (1969).

149. Securities Act Concepts, 61 Fed. Reg. at 40,045.

150. The Advisory Committee recommended a pilot program limited to issuers that have previously registered at least one public offering under the Securities Act, have fulfilled the reporting requirements of the Exchange Act for two years, have a public float of at least \$75 million, and have securities listed on the New York Stock Exchange, American Stock Exchange or NASDAQ NMS. *Id.* at 40,045 n.11.

151. This registration statement may be used for any kind of security offering and all offerings could be subject to liability under Section 11 of the Securities Act. *Id.* at 40,045.

152. For a discussion of the disclosure enhancements recommended by the Advisory Committee, see *id.* at 40,050 n.45.

153. *Id.* at 40,045.

file a registration statement for the company once, and then when it wanted to make a public offering, the company would merely need to provide information regarding that specific offering, such as the offering price of the securities and the underwriter. Such a system would alleviate the burdensome requirements accompanying complete registration currently imposed every time the company wants to make an offering.

In response to the Advisory Committee's Report, the Commission issued a concept release to solicit comment on the best way to improve the regulation of offerings and sales of securities without compromising investor protection.<sup>154</sup> Importantly, issues raised by this release were to be discussed at the Annual Conference on Uniformity of Securities Laws held on April 28, 1997, and attended by the Commission and the North American Securities Administrators Association (NASAA).<sup>155</sup>

### 3. Sale-Based Regulation

In another change, the traditional regulatory regime based on the regulation of offers has moved towards a sale-based system of regulation. Sale-based regulation suggests removing continued restrictions on offers provided that offers continue to be subject to the antifraud provisions of the Securities Act and current regulations contribute to prohibit the sale of securities in violation of mandatory disclosure requirements.<sup>156</sup> Support for this trend comes from Linda Quinn, former Director of the SEC's Division of Corporation Finance.<sup>157</sup>

In a step toward this type of approach, "test the waters" exemptions of offerings have been granted so that solicitation of offers may be made in advance of disclosure requirements.<sup>158</sup> By

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154. Securities Uniformity; Annual Conference on Uniformity of Securities Laws, Securities Act Release No. 33,7413, 62 Fed. Reg. 17,653, at 17,653 (1997).

155. *Id.* Members of the North American Securities Administration Association represent all 50 states, Puerto Rico, Canada, and Mexico. John Perkins, *Promoting A Registered SCOR Offering on the Internet* (visited Nov. 16, 1997) <<http://www.scor-net.com/articles/perkins1.htm>>.

156. Weirick, *supra* note 5, at B6.

157. *Id.* "In her view, regulatory restrictions on offers, including presumably, broadly disseminated Internet communications, are unnecessary so long as (i) investors have an opportunity to receive the information mandated by the Securities Act before making their investment decision and (ii) offer communications would not cause investors to overlook mandated disclosures." *Id.*

158. Solicitations of Interest Prior to an Initial Public Offering, Securities Act Re-



regulating sales and exempting offers, "testing the waters" allows issuers considering public offerings of securities for which there is no established market to determine whether there is any investor interest in their securities before undertaking a full-scale offering and incurring the costs associated with disclosure requirements.<sup>159</sup> This is an important development because it seems to be a precursor to later exemptions granted in the Internet area.

*B. Borrowing from the States: The Pennsylvania and North American Securities Administrators Association Plans*

One of the most problematic issues facing the SEC is when to require registration of securities offerings published offshore via the Internet that are potentially accessible to U.S. investors. One proposal is to adopt the Pennsylvania method of regulation. Pennsylvania notes that certain issuers do not intend to sell or offer securities in Pennsylvania.<sup>160</sup> However, communications made on the Internet usually are directed to anyone who is able to access the Internet. This would include persons living in Pennsylvania. Therefore, Pennsylvania has taken steps to provide an exemption from registration for offerings over the Internet that satisfy certain conditions.<sup>161</sup> First, the offer must indicate that the securities are not being offered to persons in Pennsylvania.<sup>162</sup> Second, the offer must not be directed at any person in Pennsylvania by other means.<sup>163</sup> Finally, sales of the issuer's securities are not permitted in Pennsylvania as a result of the Internet offer.<sup>164</sup>

Criticism against the adoption of this plan came from Meredith Cross, Deputy Director, Division of Corporation Finance of the SEC, when she commented that adopting such an exemption on a federal level may be "too limiting."<sup>165</sup> Cross was

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lease No. 33,7188, 60 Fed. Reg. 35,648, at 35,648 (1995).

159. *Id.* at 35,648-49.

160. In re: Offers Effected Through Internet That Do Not Result in Sales in Pennsylvania, 1995 Pa. Sec. LEXIS 71, Aug. 31, 1995.

161. *Id.*; Bagley & Arledge, *supra* note 142, at B16.

162. In re: Offers Effected Through Internet That Do Not Result in Sales in Pennsylvania, 1995 Pa. Sec. LEXIS 71, Aug. 31, 1995.

163. *Id.*

164. *Id.*

165. Wallman Urges Consideration, *supra* note 27, at 1338.

concerned that a problem might arise if an issuer avails itself of an exemption, then later changes its mind and decides it wants to sell securities to even just one U.S. investor.<sup>166</sup> Since the entire issue may not be offered or sold to U.S. investors, selling to one U.S. investor would render the exemption unavailable to the entire issue.<sup>167</sup>

A similar approach, which may remedy Cross's concern, was adopted by NASAA on January 7, 1996.<sup>168</sup> This resolution unanimously endorsed the exemption adopted by the State of Pennsylvania.<sup>169</sup> Under the NASAA resolution, offerings made on the Internet may be exempted when two conditions are satisfied.<sup>170</sup> First, the offering must indicate that the securities are not being offered to residents of the states where the offering is not registered, and second, an offer may not be directed to any person in the state by the issuer.<sup>171</sup> Moreover, the offer must be registered in at least one state before it can be posted on the Internet.<sup>172</sup> Thus, the offer will be exempt so long as no other information about the offering is directed to a resident of a state where the security is not registered, and the offering notes either the states in which it is valid or the states in which it is invalid.<sup>173</sup> As a result, if a resident of a state where the offering is not valid requests information about the offering, the issuer may only reply that the security is not registered in that state.<sup>174</sup> However, those inquiries allow the issuer to evaluate the level of interest in a particular state.<sup>175</sup> In this way, this approach remedies concerns raised by the Pennsylvania plan. This follows the "test the waters" approach. If the demand for information by residents of a particular state is high, then the issuer may decide to register the security in that state.<sup>176</sup>

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166. *Id.*

167. For an analogous example, see COX ET AL., *supra* note 18, at 355.

168. Interpretation Regarding Use of Electronic Media, 61 Fed. Reg. at 42,148 n.14; Perkins, *supra* note 155. Members of the North American Securities Administration Association represent all 50 states, Puerto Rico, Canada, and Mexico. *Id.*

169. Perkins, *supra* note 155.

170. NASAA Internet Resolution (visited Nov. 16, 1997) <<http://www.nasaa.org/bluesky/guidelines/resolu.html>>.

171. *Id.*

172. *Id.*

173. *Id.*

174. Perkins, *supra* note 155.

175. *Id.*

176. *Id.*

While this approach has played an important role in the future regulation of intrastate offerings, it has also been viewed as a potential model for global regulation. With the advancement of Internet technology, regulators are seeking ways to adapt the federal securities laws to respond to the dissolution of geographical boundaries. Linda Quinn showed support for the NASAA model.<sup>177</sup> The benefit in adopting this plan is that it would allow an issuer to register an offshore offering published on the Internet after the offer, but not after the sale of securities.<sup>178</sup> Hence, the issuer avoids the regulatory provisions of the Securities Act prohibiting offers made without the filing of a registration statement.<sup>179</sup> Yet, critics argue that there is a conceptual problem with creating this type of exemption because the SEC first has to assert jurisdiction over foreign offerings.<sup>180</sup> It is not clear whether the SEC can or should assert jurisdiction over certain foreign offerings.<sup>181</sup>

One thing is certain: the future international regulation of Internet offerings is unsettled. Issuers of Internet offerings will face compliance issues under the securities laws of foreign jurisdictions.<sup>182</sup> At this stage, foreign securities regulators are just beginning to address Internet issues.<sup>183</sup>

While it is impossible to determine presently, other regulators may adopt an approach similar to those proposed by Pennsylvania and NASAA.<sup>184</sup> However, even if the Pennsylvania or NASAA plan is adopted on a global level, the same protections implicit in our system of federalism will be absent. Presently, there is no existing global watchdog that has the capacity to serve a role analogous to the role our federal government plays

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177. *Wallman Urges Consideration*, *supra* note 27, at 1338.

178. *Id.*

179. *Id.*

180. *Id.*

181. According to Michael D. Mann, former director of the SEC Office of International Affairs, "our current oversight is based on borders. [W]hen you play in our markets you play by our rules, [but now with the borderless information age] we need a clear new statement of what is our market. Asserting jurisdiction is like the old 'minimum contacts' analysis." *Departing SEC International Office Head Reflects on Key Issues*, 9 Int'l Sec. Reg. Rep. No. 22 (Oct. 21, 1996). For a discussion of jurisdictional issues raised by Internet securities offerings, see generally Kenneth W. Brakebill, *The Application of Securities Laws in Cyberspace: Jurisdictional and Regulatory Problems Posed by Internet Securities Transactions*, 18 HASTINGS COMM. & ENT. L.J. 901 (1996).

182. Weirick, *supra* note 5, at B5; Allio & Lloyd, *supra* note 32.

183. *Id.*

184. *Id.*

in capturing and prosecuting violators that escape from state prosecution.<sup>185</sup>

### *C. Coordination Between Regulators in the Western Hemisphere*

The integrity and depth of the U.S. market attracts increasing numbers of foreign issuers who try to raise capital for their companies.<sup>186</sup> In 1995, approximately \$90 billion was raised by foreign offerings of securities in U.S. markets, and since January 1995, 119 foreign companies from twenty-four countries have registered with the SEC.<sup>187</sup> At the close of 1995, there were 744 foreign issuers from forty-five countries that had registered in the United States.<sup>188</sup> This internationalization of U.S. markets is beneficial for the market and investors alike.<sup>189</sup> While strengthening the leading role of the U.S. market, it also gives U.S. investors a wider variety of investment options.<sup>190</sup>

However, issues regarding regulation arise when the offerings are not registered with the SEC. There is a legitimate concern about Internet postings by exchanges operating in countries that permit the market participants to conduct business without adequate regulation.<sup>191</sup> Such offerings may be accessible to U.S. investors even though they are not registered in accordance with the U.S. securities laws. One way to protect American investors from cross-border offerings of unregistered securities is to raise the integrity of the other markets within the Western Hemisphere and to promote the internationalization of the market. However, promoting the internationalization of the market requires coordination among international regulators.<sup>192</sup> This mission is complicated by the fact that the regulatory systems currently in place are founded on such differing fundamental principles.<sup>193</sup>

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185. Millspaugh, *supra* note 70, at 355.

186. Levitt Testimony, *supra* note 6, at \*24.

187. *Id.* at \*25.

188. *Id.*

189. *Id.* at \*24.

190. *Id.*

191. *Internet Issues*, *supra* note 65.

192. *Id.*

193. Jane C. Kang, *The Regulation of Global Futures Markets: Is Harmonization Possible or Even Desirable?*, 17 J. INT'L L. BUS. 242, 246 (1996); see also Millspaugh, *su-*

An SEC study concluded that "[t]he degree to which the world's securities markets have become internationalized ... is unprecedented."<sup>194</sup> In the same way, the complete disclosure mandated by the SEC is gaining acceptance in the Western Hemisphere.<sup>195</sup> It has been embraced recently as an essential ingredient to the integration of our markets by regulators from the United States, Latin America, and Canada.<sup>196</sup> Nevertheless, as of 1994, Brazil and Colombia ranked among the ten countries with the worst annual disclosure according to the Center for International Financial Analysis & Research in Princeton, New Jersey.<sup>197</sup>

In a step towards integration, the multijurisdictional disclosure system between the United States and Canada became effective on July 1, 1991.<sup>198</sup> This disclosure system removes unnecessary impediments to transnational capital formation.<sup>199</sup> Canadian companies that meet certain eligibility criteria are permitted to satisfy the U.S. securities laws' registration requirements by using accepted Canadian documents.<sup>200</sup> These criteria include a three year history reporting with a Canadian securities regulatory authority, and specified size tests of minimum market value or public float or both.<sup>201</sup> Canadian Securities Administrators established a similar multijurisdictional disclosure system in Canada.<sup>202</sup> Critics argue that these meas-

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*pra* note 70, at 371-72.

194. Michael P. Malloy, *Bumper Cars: Themes of Convergence in International Regulation*, 60 *FORDHAM L. REV.* 1, 17 (1992) (quoting from Staff of the United States Securities and Exchange Commission, Report to the Senate Comm. on Banking, Housing and Urban Affairs and the House Committee on Energy and Commerce Concerning Internationalization of the Securities Markets (1987) at I-1).

195. See Communiqué of the Council of Securities Regulators of the Americas, International Series Release No. 814, 59 S.E.C. Docket (CCH) 1036, 1037 (May 31, 1995) (stating that the Council of Securities Regulators of the Americas (COSRA) was committed to full and fair disclosure as the proper method to promote the integrity of the securities markets).

196. *Id.*

197. Debbie Galant, *Too Much Too Soon*, *INSTITUTIONAL INV.*, Sept. 1994, at 79.

198. SEC Issues Release to Implement Cross-Border System with Canada, 23 *Sec. Reg. & L. Rep. (BNA)* No. 26, at 1000 (June 28, 1991).

199. *Id.*

200. *Id.*

201. Multijurisdictional Disclosure and Modifications to the Current Registration and Reporting System for Canadian Issuers, SEC Release No. 33-6902, 49 S.E.C. Docket (CCH) 260 (June 21, 1991).

202. SEC Issues Release to Implement Cross-Border System with Canada, 23 *Sec. Reg. & L. Rep. (BNA)* No. 26, at 1000 (June 28, 1991).

ures have met with limited success.<sup>203</sup> Nevertheless, it is encouraging that some attempts are being made to share resources.

Additionally, over the past few years, the SEC has entered into Memoranda of Understanding with twenty-seven countries.<sup>204</sup> Within the Western Hemisphere, these countries include Canada, Argentina, Brazil, Chile, and Mexico.<sup>205</sup> These MOUs provide for mutual assistance to "facilitate the performance of securities market oversight functions," enforce the regulations of securities exchanges, inspect or examine investment businesses, and grant licenses, waivers or exemptions for the conduct of investment businesses.<sup>206</sup> However, they also provide for mutual assistance in investigating, litigating, or prosecuting cases where critical information needed by the requesting Authority is located within the jurisdiction of the requested Authority.<sup>207</sup> In this way, they are instrumental to enforcement investigations of cross-border securities transactions.<sup>208</sup> Pursuant to these MOUs, the SEC requested assistance from foreign governments 230 times in 1995 alone.<sup>209</sup> Even though bilateral approaches like these may be effective in easing difficulties in securities regulation arising out of the relationship between the

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203. Seligman, *supra* note 73, at 663 n.76.

204. Levitt Testimony, *supra* note 6, at \*26.

205. See, e.g., Memorandum of Understanding Between the United States Securities and Exchange Commission and the Ontario Securities Commission, Commission Des Valeurs Mobilières Du Quebec, and the British Columbia Securities Commission, SEC International Series Release No. 6, 1988 SEC LEXIS 5278 (Jan. 7, 1988); Memorandum of Understanding Between the United States Securities and Exchange Commission and the Comisión Nacional De Valores of Argentina on Consultation, Technical Assistance, and Mutual Assistance for the Exchange of Information, Dec. 9, 1991, *reprinted in* 50 S.E.C. Docket (CCH) 674 (Dec. 18, 1991); Memorandum of Understanding Between the United States Securities and Exchange Commission and the Brazil Comissão De Valores Mobiliários, July 1, 1988, *reprinted in* 43 S.E.C. Docket (CCH) 197 (July 1, 1988); Memorandum of Understanding Between the United States Securities and Exchange Commission and the Superintendencia De Valores y Seguros of Chile on Consultation, Technical Assistance, and Mutual Assistance for the Exchange of Information, June 3, 1993, *reprinted in* 54 S.E.C. Docket (CCH) 542 (June 3, 1993); Memorandum of Understanding Between the United States Securities and Exchange Commission and the Comisión Nacional De Valores of Mexico on Consultation, Technical Assistance, and Mutual Assistance for the Exchange of Information, Oct. 18, 1990, *reprinted in* 47 S.E.C. Docket (CCH) 716 (Oct. 22, 1990).

206. See, e.g., Memorandum of Understanding Between the United States Securities and Exchange Commission and the Comisión Nacional De Valores of Mexico on Consultation, Technical Assistance, and Mutual Assistance for the Exchange of Information, Oct. 18, 1990, *reprinted in* 47 S.E.C. Docket (CCH) 716, 718 (Oct. 22, 1990).

207. *Id.*

208. Levitt Testimony, *supra* note 6, at \*26.

209. *Id.* at \*26 n.10.

two specific countries, they fail to address multilateral issues and concerns.<sup>210</sup>

Multilateral organizations such as the Council of Securities Regulators of the Americas (COSRA) hope to continue to promote the integration of markets in the Western Hemisphere.<sup>211</sup> COSRA, which was founded in 1992, is an organization of securities regulators from North, Central, and South America and the Caribbean.<sup>212</sup> One way COSRA attempts to increase market integrity is by promoting the development of an "effective market oversight" in each country represented in COSRA.<sup>213</sup> In attempting to increase market integrity in the Western Hemisphere, COSRA adopted the following principles: "impose responsibility and accountability for fair and efficient markets on market operators and intermediaries; monitor compliance with securities and futures laws and applicable self-regulatory organization rules; and establish or bolster an effective enforcement system."<sup>214</sup> These goals indicate an affirmative attempt on the part of securities regulators in the Western Hemisphere to work together to raise the level of efficiency and integrity in our markets. While it is doubtful that an organization like COSRA will fill the role of global "watchdog" in the future, at least it is currently instrumental in raising the standards for market participants in the Western Hemisphere.

#### *D. Educating Investors*

Educating investors is one of the best defenses against fraud. Education is a preventative measure, that will enable investors to better protect themselves. This should reduce the number of successful fraudulent schemes, and thus, minimize the need for enforcement actions. The Commission's Office of Investor Education and Assistance commits its effort to educating investors.<sup>215</sup> With regard to Internet fraud, this office issues

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210. See generally Malloy, *supra* note 194, at 10.

211. Levitt Testimony, *supra* note 6, at \*26.

212. Communiqué of the Council of Securities Regulators of the Americas, International Series Release No. 814, 59 S.E.C. Docket (CCH) 1036 (May 31, 1995). Participating countries include: Argentina, Bolivia, Brazil, Canada, Chile, Ecuador, Mexico, Paraguay, Peru, Trinidad and Tobago, Uruguay, and the United States. *Id.* at 1037-38.

213. *Id.* at 1036.

214. *Id.*

215. *Octagon Tech. Group*, 62 S.E.C. Docket (CCH) 380.

a flyer for investors with practical advice on how to recognize, avoid, and report Internet fraud.<sup>216</sup> Likewise, NASAA also educates investors about the risks and opportunities on the Internet.<sup>217</sup>

In a major advancement, COSRA recently established the first-ever Hemisphere-wide investor education campaign.<sup>218</sup> As part of this campaign, COSRA, joined by NASAA and the SEC, is sponsoring "Saving and Investing Education Week," which is scheduled for March 29-April 4, 1998.<sup>219</sup> Activities planned specifically for the United States include: "a series of Investors' Town Meetings, investment seminars, workshops and in-school programs."<sup>220</sup> NASAA President, Denise Voigt Crawford said, "State securities regulators, working with the SEC, will do all we can to help make this the most exciting and comprehensive investor education effort ever."<sup>221</sup>

## VI. CONCLUSION

As previously highlighted, incredible new opportunities are being created by integrating Internet technology into securities transactions. Furthermore, as Internet technology advances and changes the form of securities offerings, securities offerings will encourage the further development of Internet technology, thus suggesting a reciprocal relationship between the Internet and securities offerings. However, in view of the increasing popularity of the Internet and prospective advancements, it will only become more important to resolve the issue of how to effectively regulate Internet offerings of securities.

Similarly, while new opportunities are created for legitimate issuers, new opportunities are also created for illegitimate issuers. Thus, the Internet may cause increases in fraud and deceit.

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216. *Id.* A copy of the SEC's Office of Investor Education and Assistance flyer can be obtained by calling the SEC's information line at 1-800-SEC-0300, by visiting the SEC's Web site at <http://www.sec.gov>, or by writing to the Office of Investor Education and Assistance, U.S. Securities and Exchange Commission, 450 Fifth Street, N.W., Mail Stop 11-2, Washington, DC 20549. *Id.*

217. *Investor education* (visited Nov. 16, 1997) <<http://www.nasaa.org/investoredu/index.html>>.

218. *First-Ever Hemisphere-Wide Investor Education Campaign Planned* (visited Feb. 4, 1998) <<http://www.sec.gov/news/cosra1.htm>>.

219. *Id.*

220. *Id.*

221. *Id.*



Increased fraud, compounded by the limited number of SEC enforcement staff, the lack of boundaries on the Internet, and virtual anonymity, makes the likelihood of efficient enforcement of all violations of federal securities laws involving the Internet remote.

While the form that future regulation of Internet offerings and fraud will take is unclear, it is necessary for regulators in the Western Hemisphere to cooperate in coordinating standards and approaches to Internet regulations.<sup>222</sup> Additionally, an increase in self-regulation by investors is essential to controlling fraudulent Internet IPOs. As more investors become informed of the risks inherent in Internet transactions and seek to protect themselves, the job of securities regulators will be facilitated. Investors must play a primary role in protecting their own investments in these changing times.

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222. *Departing SEC International Office Head Reflects on Key Issues*, *supra* note 181.

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